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Community Health Systems surprises skeptics

Wayne T. Smith's risky Triad deal pays off 2 years later

BY GETAHN WARD • THE TENNESSEAN • NOVEMBER 8, 2009

Wayne T. Smith remembers the wall of skepticism he faced after engineering a $6.8 billion acquisition that doubled the size of Franklin-based Community Health Systems overnight.

Critics of the deal to acquire Plano, Texas-based Triad Hospitals said its doctors would leave in droves because of Community's more centralized, performance-driven culture. They feared it would be hard for a company accustomed to being the sole provider in rural towns to absorb Triad's portfolio of hospitals in large and midsize cities. And never mind the fact that up until then Community had acquired about one to two hospitals per year; now they were swallowing 54 in a single gulp.

Wayne T. Smith, chief executive officer of Community Health Systems in Franklin, speaks to a group of physicians from around the country. Smith engineered Community Health Systems' purchase of Triad Hospitals two years ago amid a flurry of concerns about differences in how they operated and the markets they served.
(JEANNE REASONOVER / THE TENNESSEAN)

Two years later, Smith seems to have defied everyone's low expectations, though he's the first to admit that work remains for Community to realize the full potential of the Triad acquisition.

"I was very worried Triad wasn't necessarily an easy company to integrate," said Sheryl Skolnick, an analyst at Pali Capital in New York. "I thought I'd be giving them a 'D,' so that's an improvement. But then again, I'm a hard grader." Skolnick now grades Community a "B+."

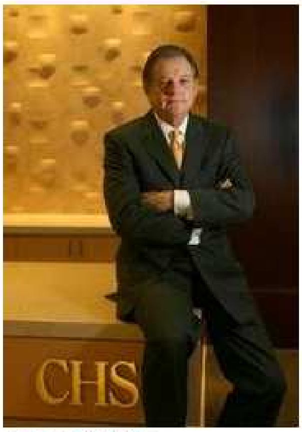
Other analysts, and Smith himself, are more generous, grading the owner and operator of 122 hospitals in 29 states between an "A" to "A+" for how it has handled absorbing Triad.

"The skeptics of that transaction have been proven wrong," said Frank Morgan, an analyst at RBC Capital Markets in Brentwood.

By year-end Community expects $270 million in cost savings since the Triad acquisition, exceeding its target. The company has achieved that by getting Triad hospitals to buy more supplies in bulk, obtaining better managed care rates from the leverage gained through Community's more centralized structure, and increasing productivity and efficiencies in operations.

Those efforts have improved operating margins — a measure of profitability over net revenue — at the former Triad hospitals. They're up to near 14 percent, close to the range of 14 percent to 15 percent that Triad saw before declining to 11 percent to 12 percent before it was acquired.

Overall, margins at hospitals Community has owned a year or more are 14.4 percent year-to-date. Still, Smith sees room for margin growth at ex-Triad locations and at other hospitals it has acquired since the Triad deal. "We have a lot of room for improvements," he said. "This is one of the greatest investment opportunities in health care."



Community Health Systems CEO Wayne T. Smith at his company's headquarters in Franklin. (JEANNE REASONOVER / THE TENNESSEAN)

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Skolnick agreed, pointing out that Community hasn't seen a jump to its historical margin rates in the mid-to-high-teens that it'd targeted.

"Could we have seen results that were better? Absolutely," opined Whit Mayo, an analyst at Robert W. Baird & Co. in Nashville, adding that the acquisition has been successful so far despite a difficult environment for hospitals. "Over the long term, there's still going to be a good amount of skepticism as to whether this was the right thing to do long term for shareholders."

Skolnick also said Community could be more aggressive in reducing costs, suggesting that the company missed a chance to cut benefits in a recession without backlash from workers. That could come back to bite Community, she said, adding that competitors who made cuts and are more lean could benefit through higher margins as patient volume increases, she said.

Smith counters by citing pride in improving results without discontinuing matching 401(k) contributions, cutting employees' pay or layoffs. "We've done this through good, old-fashioned management," he said, adding that companies that make such cutbacks would have to restore them eventually if they want to be competitive.

Making most of expertise

Community's earnings guidance for next year factors in two acquisitions. The company is pursuing a dual strategy of seeking opportunities in rural areas and looking to acquire hospitals in midsize cities. It's a good time to be looking: Prices are down to 50 percent to 60 percent per dollar of net revenues from the 80 cents that Community used to pay, Smith said.

Among recent acquisitions, Community bought a Birmingham, Ala.-based sports medicine and orthopedics practice whose doctors had practiced at a hospital owned by rival Tenet Healthcare. Smith said the deal is part of the company's

strategy to leverage its expertise in specialties across a network of hospitals and to improve quality by utilizing best practices.
Standardized quality initiatives include a practice where nurses across the company visit patient rooms each hour.

Quint Studer, owner of an outcomes-based consulting company in Gulf Breeze, Fla., said that Community has been effective in getting nurses to comply because it communicates well why such a practice is needed, including reduced patient falls, infections and other results.

"When a nurse understands the why, they're going to do the behavior," he said. "If the organization don't take time to explain the why, you won't get consistent behavior."

Last week, Community invited 15 cardiac surgeons, cardiologists and other specialists from its hospitals nationwide to its headquarters to provide an update on best practices to improve clinical care companywide. "If this kind of collaboration exists, then corporate is going to do well and physicians are going to do well," said Dr. J. David Amlicke, an interventional cardiologist employed with the company's Gateway Medical Center in Clarksville, Tenn. "That's a win, win."

Watching, waiting

Even as Community pursues strategies for growth, analysts see headwinds that could play a role in shaping trends for the company and hospitals industry. "The big question is going to be: Assuming the labor market remains soft and therefore presumably more people will be uninsured, would the industry be able to manage through that?" said Kemp Dolliver, an analyst with Avondale Partners.

And with state budgets under pressure, Medicaid reimbursements could be cut more next year, he added.
It remains to be seen exactly what any health-care reform bill Congress passes would mean to Community and other hospital industry players. "Reform should net out favorably for them," Dolliver said. "It's just going to be less uncompensated care, and there would be fewer expenses associated with managing that part of their business."

This year, Community is providing $2.4 billion worth of care that the company won't get paid for. That's one reason Smith is watching the debates in Washington, favoring coverage for as many people as possible.

That would reduce bad-debt expense involved in caring for the uninsured.

Smith isn't a fan of the idea of a public option to compete alongside private insurers, adding there's no need to reinvent the wheel when existing vehicles such as Medicare and Medicaid programs could be used to bring the uninsured into the system.
"Why start over and spend all the money to do that is a major question for all of us," he said, adding that unintended actuarial results that might come from a public option could hurt insurers and consumers, as well.

Smith, meanwhile, has been rewarded for Community's success with Triad. Last year, his estimated $13.9 million pay package was the biggest among CEOs of the 10 largest companies by revenues in the acute-care hospitals, health insurance, and specialty-care provider sectors.

Smith attributes his haul in part to a bonus and retention incentives related to the Triad deal, adding shareholders have been rewarded, as well, through Community's performance.

Community's employees, including 1,600 in Nashville among 90,000 nationwide, deserve credit, Smith added. "It's about quality of the people we have in this organization," he said. "The great job they do — day in, day out — made the transaction so much easier."